0.8 Leadership and Governance

Competitive session

UNPACKING DIRECTOR FINANCIAL LITERACY: A DELPHI STUDY FROM AUSTRALIA

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ABSTRACT

The 'Centro case' confirmed that each individual director is responsible for financial governance and must be able to 'read and understand' financial statements. Despite the centrality of director financial literacy to directors duties, practitioner and academic literature have failed to clearly define or provide evidence-based reliable measures of director financial literacy. This paper seeks to address this weakness by presenting the initial results of a Delphi study on unpacking the conceptualisation of director financial literacy. We have found that director financial literacy involves more than reading and understanding financial statements. Rather, it encompasses capabilities in applying accounting concepts to the analysis and evaluation of financial statements. As such director financial literacy may be more accurately described as 'director accounting literacy'.

KEYWORDS

Accountability; Agency; Board composition; Board effectiveness; Board of directors; Board roles.

The board of directors plays a fundamental role in the governance of the modern corporation. The board constitutes a key internal control mechanism by monitoring managers to assure they are acting in the best interests of shareholders (Baysinger & Hoskisson, 1990; Johnson, Daily, & Ellstrand, 1996; Zahra & Pearce, 1989). Although the literature recognizes the importance of board monitoring (Daily, Dalton, & Cannella, 2003; Zahra & Pearce, 1989), the perceived passivity and inability of boards to prevent well-known corporate scandals (e.g. Enron, HIH, James Hardie, Centro and ABC Learning Centres) have fuelled societal criticism about the extent to which directors perform their duties.

In the aftermath of these scandals, the influence of director financial capability on the integrity of financial reporting and oversight has emerged as an important area of concern shared by regulators, practitioners and scholars. Such concern has indicated that director capability and the legal duty of due care and diligence are linked and required of all directors, not just those serving on the boards of listed companies (Australian Securities and Investment Commission, 2014; Golding, 2012; Hill, 2012, 2013; McRobert, 2009, 2014; Sharp, 2012). In this context it is also noteworthy that a recent nation-wide survey of directors in Australia revealed that on average directors were perceived to have a poor understanding of accounting concepts and requirements (Financial Reporting Council, 2012).

Despite the practical significance of director financial capability surprisingly few studies have explored this issue in-depth. To date most research has been conducted in the US context, applying quantitative methods to identify relationships between director financial capability and corporate performance (Abernathy, Herrmann, Kang, & Krishnan, 2012; Agrawal & Chadha, 2005; Güner, Malmendier, & Tate, 2008; Sultanaa, Van der Zahn, & Cahan, 2013). These efforts have produced mixed results, although there is a general tendency in the literature towards a slight positive impact of audit committee financial capability on firm governance and performance (Coates, Marais, & Weil, 2007; Kelly & Dimovski, 2012; Visvanathan & Krishnan, 2008).

Definitional ambiguity and related measurement issues have also been problematic. Studies have measured financial capability using a variety of definitions derived from legislation (Williams, 2005), stock exchanges (Gendron, Bedard, & Gosselin, 2004; Sultanaa et al., 2013), regulators (Defond, Hann, & Hu, 2005; Visvanathan & Krishnan, 2008) and inquiries (Jeanjean & Stolowy, 2009). Prior studies have divided financial capability into two levels: ‘financial experts’ being those with formal qualifications and work experience in accounting or related areas; and ‘financial literates’ being those who do not have these qualifications or experience but are expected to be able to ‘read and understand’ fundamental financial statements (McDaniel, Martin, & Maines, 2002; Vinnari & Näsi, 2013). Further confusion arises where some notable studies have used the term ‘financial literacy’ to describe what other studies label ‘financial expertise’ (Coates et al., 2007; Giacomino, Akers, & Wall, 2009; Giacomino, Wall, & Akers, 2011). The terms ‘financial literacy’ and ‘financial expertise’ have also been challenged as misnomers given the legal focus and interpretation of such capabilities are predominantly concerned with accounting rather than broader financial capabilities (Coates et al., 2007; Giacomino et al., 2009).

Reliance on a variety of contested and inferred measures of competence and the limited data used in archival studies have been attributed as underlying flaws in the conceptualisation and operationalization of director financial literacy (Carcello, Hermanson, & Ye, 2011; Rose & Rose, 2008; Vinnari & Näsi, 2013), that have hampered the comparability of studies (Carcello et al., 2011; Carcello, Hollingsworth, & Klein, 2006; DeFond, Francis, & Carcello, 2005). At a deeper level, however, these problems point to the conceptual challenge of how do we know what specific capability is required for an individual director to fulfil the duty of due care and diligence; and how can this capability be verified? It is, therefore, not surprising that scholars and practitioners agree that director financial literacy should be better defined, measured, and monitored (Ahrens, Catasús, & Johed, 2014; Coates et al., 2007; Financial Reporting Council, 2012; Giacomino et al., 2009; Giacomino et al., 2011; Rose & Rose, 2008; Vinnari & Näsi, 2013; Weil, Coates, & Laurentius, 2006). It is these specific challenges that this exploratory study investigates through the following research questions:

(i) How do experts frame director financial literacy?

(ii) How do experts identify a financially literate director?

(iii) Which are the central financial concepts for directors to understand?

By addressing these research questions in the Australian context we aim to contribute to the literature in two ways. *First*, by exploring in-depth what it means for a director to be financially literate we hope to resolve some of the confusion that is hampering further scholarly advancement in this area (Coates et al., 2007; Financial Reporting Council, 2012; Giacomino et al., 2011; Vinnari & Näsi, 2013). Our first empirical results highlight that director financial literacy is a complex multi-dimensional construct that needs to be measured as such. *Second*, we believe that unpacking this construct is an important and necessary first step in developing a reliable and direct measure of how well each individual director is able to apply their financial capability to board work. Given the assumed relationship between director financial literacy, governance failures and economic and societal outcomes, such a tool could potentially help (i) regulators to codify and verify director financial literacy and (ii) support director education and development programs by highlighting whether and in which areas current and potential directors might need further financial training. By identifying the minimum critical financial concepts directors need to understand this study helps to focus such an endeavour.

METHODS

Director financial literacy is a nascent area of academic research that has stalled largely due to conceptual ambiguity and disagreement across expert domains over the depth and breadth of the financial capability required by each individual director (Ahrens et al., 2014; Carcello et al., 2011; Carcello et al., 2006; Coates et al., 2007; Jeanjean & Stolowy, 2009; McDaniel et al., 2002; Vinnari & Näsi, 2013). The main objective of this research is to achieve agreement across expert domains on what it means for a director to be financially literate. A classic Delphi study was selected as the most suitable means for achieving an agreed conceptual framework, as this method "is a structured process for collecting and distilling knowledge from a group of experts by means of a series of questionnaires interspersed with controlled opinion feedback" (Streveler et al., 2011, p. 970). Distinguishing features of the Delphi method are that participation is limited to experts and the iterative way that it that "encourages individual viewpoints, while striving towards a core consensus" (Pickard & Childs, 2007, p. 131). The method, therefore, does not depend on statistical methods for sampling. Rather, it is a group decision-making mechanism for experts with a deep understanding of the issue under investigation (Okoli & Pawlowski, 2004). The method derives its name from the Ancient Greek oracle and was developed in the 1950's by the Rand Corporation as a means for forecasting and solving complex and ambiguous problems (McLeod & Childs, 2007).

Overview of the Delphi method

For the purposes of our research, the overall aim is to progressively move toward a moderated consensus on how experts conceptualise and identify director financial literacy. Our focus is on identifying the minimal financial capability required for each individual director serving on any board or equivalent governing body. The Delphi method involves distributing a series of online questionnaires to participants over successive rounds. At the completion of each round, the responses are de-identified, collated and distributed back to participants for review, reflection and feedback. The results of each round are also used to formulate the questionnaire for the next round. The rounds continue until an acceptable level of agreement has been reached within the panel of participants. Questionnaires move from open-ended questions requiring qualitative data analysis techniques through to closed questions requiring quantitative data analysis to determine the level of agreement within the panel. As such, it is a mixed method. Figure 1 provides an overview of the typical structure and sequence of the Delphi study on director financial literacy.

A key advantage of the Delphi method is that it reduces bias stemming from individual experiences and expertise. It also minimises group effects (e.g. dominant individuals, agenda pushing and early judgements about comments) while allowing each participant to contribute their views when and how they wish to do so. Members of the panel remain anonymous to each other until the completion of the project but have anonymous access to the contributions made by other members of the panel (Pickard & Childs, 2007).

Participants

Selecting the right experts for panel is the 'linchpin of the method' (Green, Jones, Hughes, &

Williams, 1999, p. 200). Participants were identified and recruited through purposeful and snowball sampling. Based on the findings of the literature review there are three main expert groups associated with director financial literacy – accountants, directors and educators, as described in Figure 2.

Thirty-five experts agreed to participate in the first round of the Delphi study. A further four experts joined the panel from the second round. Each participant was asked to self-evaluate their area of expertise so that their perception of expertise could be verified with that of the researchers (McDaniel et al., 2002). Participants were also asked to identify the sector in which they had the most experience. Figure 2 presents the summary self-evaluation of expertise and experience by participants who submitted a complete questionnaire.

Data collection and analysis

A pilot study of a small group of additional experts was conducted to test each questionnaire in terms of content, comprehension and technical usability prior to its distribution to the Delphi participants. The full duration of the first round of the Delphi study was six weeks from the release of the first questionnaire through to the release of the next questionnaire. Participants were provided three weeks to submit the first questionnaire, with each participant taking 10 to 30 minutes to complete and submit the questionnaire.

The Delphi method separates idea generation or exploration (round one) from evaluation and judgement (round two onwards). For our study the first questionnaire consisted of four open-ended questions to encourage individual participants to brainstorm their views on director financial literacy. These questions were derived from the literature. All responses submitted were collated into a report and distributed to each participant for validation and, if they wish, further comment. The evaluation phase commenced with the second questionnaire which asked each participant to evaluate the relative importance of each concept identified in the first round. At the time of preparing this abstract, the second round is in progress.

Of the 35 participants who agreed to participate in the first round of the Delphi study, 29 submitted completed questionnaires by the due date. Responses were in narrative form. Examples of the comments received are provided in Table 1. Responses were analysed using open, axial and thematic coding techniques (Charmaz, 2006). Emerging from the data were 193 distinct financial concepts which were coded and organised under five themes. By way of example, the top three concepts identified under each of the themes is shown in Table 2.

RESULTS

How do experts frame director financial literacy?

The results of our study indicate that experts perceive director financial literacy as being limited to basic accounting literacy. Experts have also indicated that they perceive the cognitive capabilities required for director financial literacy to involve far more than basic comprehension skills as indicated in the phrase ‘read and understand financial statements’ currently dominating academic and practitioner literature. While the experts agree that director financial literacy does include being able to recognize and connect key accounting terms with others and the broader structures and processes in which they appear; they also propose that in defining director financial literacy it will need to include higher levels of capability such as being able to analyse statements, assess the quality of financial information and evaluate the strategic implications of all this to form an independent view of an organisation’s “financial story” as it appears in the statements.

How do experts identify a financially literate director?

Expert opinion indicates that director financial literacy is directly linked to the duty of due care and diligence as it is applied by each individual director in monitoring the financial management of an organisation. Our results indicate that experts identify a financially literate director as being one who is able to apply relevant conceptual and procedural accounting knowledge to constructively contribute to discussions and decisions relating to financial reports and statements at board meetings and form an independent opinion about the quality of financial reports and statements prior to approving them.

Which are the central financial concepts for directors to understand?

Several financial concepts were identified across all three expert domains as being necessary for each individual director to understand. Key concepts identified by the experts are shown in Table 2. The results of the first round raise further questions about how deeply each director needs to understand these concepts and the extent to which each director's capability needs to be developed as they serve in different roles (e.g. chair of the board or audit committee member) and their experience as a director grows. These questions will be addressed in subsequent rounds of the Delphi study and the project.

CONCLUSION

Whereas the notion of director financial literacy has become more important over recent years, our study started by noting that this concept is weakly defined and measured in the literature. Our research therefore set out to explore what each individual director must minimally understand if they are to have the financial capability to perform their director duties. The resulting conceptual framework from our Delphi study highlights that director financial literacy is a multi-dimensional construct encompassing more advanced cognitive capabilities than the basic comprehension skills currently dominating academic and practitioner literature. We have also found that director financial literacy is limited to a narrower sub-set of financial concepts drawn primarily from accounting domain. Our research indicates, therefore, that 'director financial literacy' may be more accurately described as 'director accounting literacy'.

Overall our findings have important implications for theory and practice. In terms of academic implications, our findings indicate that director financial literacy is a complex and multi-dimensional construct that needs to be measured as such. By introducing five dimensions of director financial literacy we extend and deepen previous conceptualisations of director financial literacy and provide a more robust framework for measuring and advancing scholarly investigations into this area. For example, by providing a platform from which evidence-based measures of financial capability can be established, our research can be used to explore the assumed relationship between director financial literacy and governance failures. It may also be used to further examine the relationship between director financial capability and group interactions in the boardroom. Moreover, it would be interesting to assess the relative importance of the various dimensions in enhancing boardroom deliberations.

In terms of practical implications, our study is a first step in developing an agreed conceptual framework and clear articulation of the conceptual and procedural capabilities required for director financial literacy. As a result reliable measures may now be developed to assess how well each individual director is able to use their financial capability for board work. Such measures may be applied in a range of contexts including pre and post course assessments to evaluate the effectiveness of director education programs and for regulatory purposes to verify that directors serving on boards do indeed have the minimal financial capability required to perform their duties as required by law. While challenging, we believe this to be a research agenda critical to understanding how each individual director's financial capability may influence the integrity of financial reporting and oversight.

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Figure 1: Overview of the Delphi study on Director Financial Literacy

Recruit experts

- Purposeful and snowball sample based on literature
- 35 experts recruited covering the following professional knowledge domains:
  - Accounting
  - Governance
  - Director education

Round 1: Generate ideas

- Questionnaire 1 based on literature review
- Questionnaire comprised of open-ended questions including:
  - *What is director financial literacy?*
  - *What concepts are difficult to understand*?
- Participants given three weeks to submit responses
- 29 completed responses submited by the due date
- Responses collated, de-identified and distributed to each member of the panel

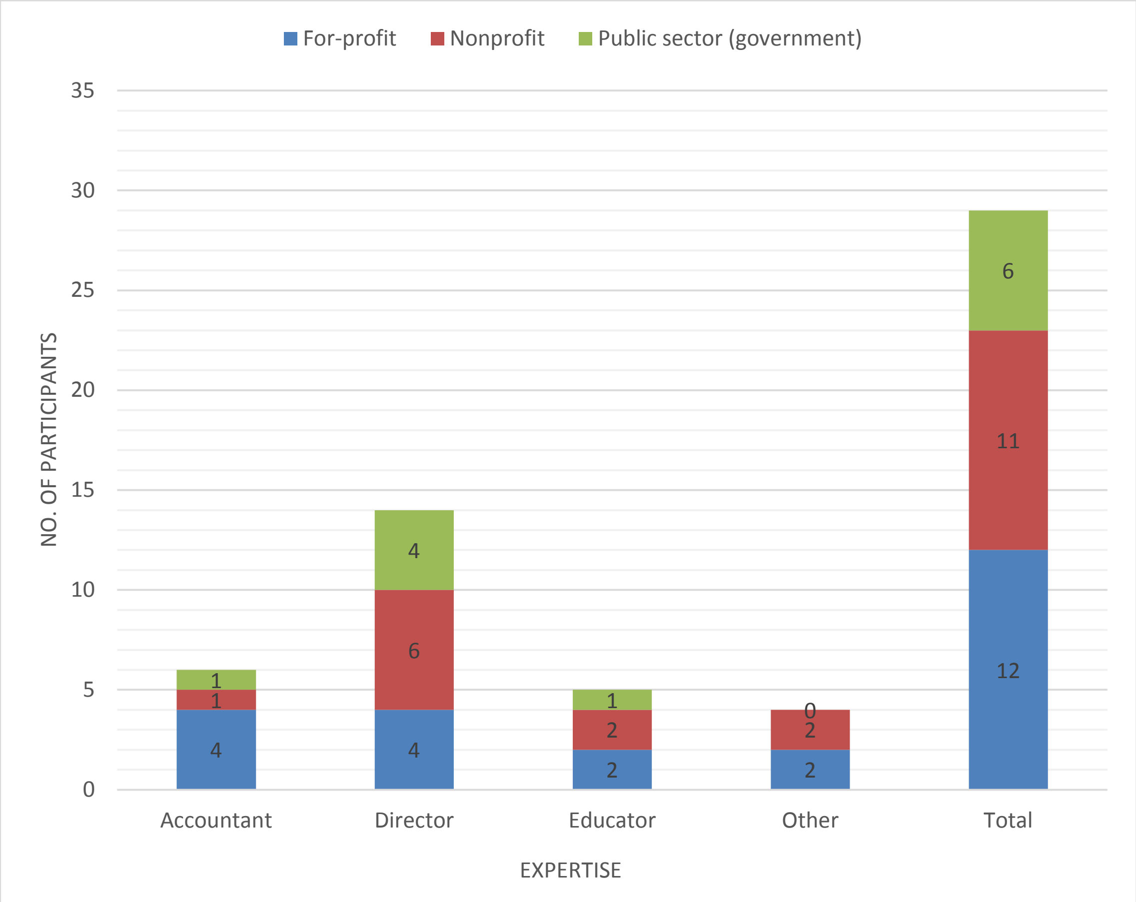
Round 2: Evaluate ideas

- Four more experts join the panel
- Questionnaire 2 based on round 1 responses
- Questionnaire comprised of closed questions with comments
- Participants asked to evaluate the relative importance of concepts grouped into 5 themes
- Particpants evaluate the concepts using a four-point scale (must, should, nice to know and not applicable)
- A glossary of concepts based on Round 1 responses and the literature is provided to assist participants with understanding the intended meaning of each item included in the questionnaire
- Participants given two weeks to submit responses
- Responses collated, de-identified, statistical analysis applied to data
- Report on responses and statistical analysis distributed to each member of the panel

Round 3+: Form consensus

- Questionnaires based on responses from previous round(s)
- Questionnaires comprised of closed questions with comments
- Participants asked to rank concepts from the most to least important
- Participants asked to rank concept from the most to least difficult to understand
- Participants asked to rank definitions from most preferred to least preferred
- The glossary is revised, updated and redistributed at the beginning of each round
- Participants given two weeks to submit responses
- Responses collated, de-identified, statistical analysis applied to data
- Report on responses and statistical analysis distributed to each member of the panel
- Rounds continue until a consensus or saturation is reached

Figure 2: Breakdown of Delphi study participants' primary area of expertise and sector experience



- **Accountant**

Formal post-graduate qualifications in accounting and experience as a practitioner or advisor in accounting, auditing or finance.

- **Director**

Board directors who have served on at least three boards within the past 10 years.

- **Educator**

Educators with experience in developing, delivering, assessing, evaluating or reviewing formal and informal accounting or director education.

Table 1: Example of responses coded into concepts and themes

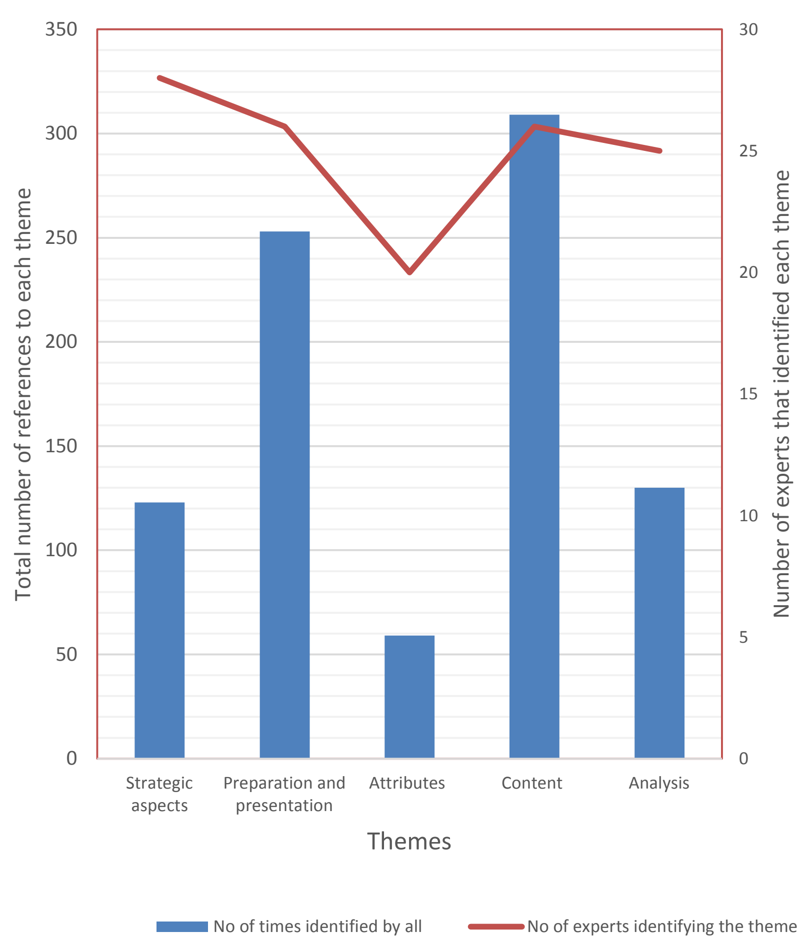
Question 1: What do you think is meant by 'read and understand financial statements'?

Consider, for example, what a financially literate board director must be able to do with the information contained in financial statements and how being financially literate relates to the role and fundamental duties of individual board directors.

Responses	Codes	Total counts for codes		Themes
		Mentioned	Experts	
A financially literate Director ought to be able to determine from the financial statements the following key understandings of the financial position of the organisation: 1. Whether the organisation is likely to be able to pay its bills as and when they fall due. 2. The financial performance of the organisation.	Financial statements	59	20	Attributes of financial reports
	Financial position	14	12	Strategic aspects of finances
	Solvency	23	18	Strategic aspects of finances
	Financial performance	23	16	Strategic aspects of finances
In this regard directors should be able to: • Understand how each of the financial statements is prepared including key accounting standards and policies which underpin them and assess whether there are matters not included in the financial statements which should be • Understand how each of the financial statements inter-relate • Understand how to assess the company's solvency • Independently form a view on whether the financial statements represent a true and fair view of the company's financial position.	Preparation of financial statements	253	26	Preparation & presentation of financial reports
	Accounting standards	32	15	Preparation & presentation of financial reports
	Accounting policies	2	2	Preparation & presentation of financial reports
	Materiality	7	7	Preparation & presentation of financial reports
	Recognition	20	11	Preparation & presentation of financial reports
	Relationships between financial statements	26	14	Attributes of financial reports
	Solvency	23	18	Strategic aspects of finances
	True and fair	6	5	Preparation & presentation of financial reports
	Financial position	14	12	Strategic aspects of finances
Read and Understand Financial Statements in my view is for directors to understand the concepts behind Assets/Liabilities/Equity/ Operating Financial Statements including Revenue and Expenses / as well as knowledge of Cash Flow. In addition there is a need for an understanding of the concepts behind financial operations including key relevant ratios for operating margins and/or gross trading profits, financial sustainability including financing capacity, financial solvency including understanding of financial risk exposures.	Assets	72	20	Content of financial statements
	Liabilities	39	17	Content of financial statements
	Equity	42	19	Content of financial statements
	Income statement	45	21	Content of financial statements
	Revenue	3	1	Content of financial statements
	Expenses	20	13	Content of financial statements
	Cash flow	21	13	Content of financial statements
	Ratios	38	15	Financial statement analysis
	Profitability	23	16	Strategic aspects of finances
	Profit	15	10	Content of financial statements
	Financial sustainability	15	11	Strategic aspects of finances
	Solvency	23	18	Strategic aspects of finances
	Financial risk	12	10	Strategic aspects of finances

Table 2: The frequency in which each theme was mentioned by all experts.

Theme	Top 3 concepts
Theme 1: Strategic aspects of an organisation's finances monitored by directors This theme encompasses the strategic aspects of the organisation's finances that each individual director needs to monitor and form judgements. It includes understanding the consequences or possible causes and effects of relevant indicators or trends. To demonstrate this capability each director, irrespective of the context in which he or she works must understand the meaning and the strategic implications of these concepts. Not knowing these concepts will have a significant adverse impact on a director's ability to perform his or her most basic duties.	1. Solvency 2. Financial performance 3. Liquidity
Theme 2: Preparation and presentation of financial reports This theme encompasses the preparation and presentation of financial reports as described in the Accounting Standards. To demonstrate this capability each director, irrespective of the context in which he or she works must understand the meaning, purpose, relationships with other concepts, and the strategic implications of these concepts. Not knowing these concepts or processes will have a significant adverse impact on a director's ability to perform his or her most basic duties.	1. Asset valuation 2. Accrual accounting 3. Financial governance
Theme 3: Attributes of financial reports This theme encompasses the attributes of financial statements and relationships between them. It includes the purpose of financial statements, definitions of statements and elements, relationships between statements, comparison of statements and limitations of statements. It excludes specific elements within the statements and financial reports e.g. Notes. Not knowing these concepts will have a significant adverse impact on a director's ability to perform his or her most basic duties.	1. Relationships between statements 2. Definitions of statements 3. Purpose of statements
Theme 4: Content of financial statements This theme encompasses the content of the four fundamental financial statements and other documentation that together form the financial reports of an organisations. Financial reports for reporting entities and others consist of the balance sheet, income statement, cash flow statement and statement of changes in equity. Additional content that needs to be understood relate to the notes to the financial statements, the director's declaration and the notion that financial statements should be true and fair in their depiction of the financial story of the entity. Not knowing these concepts will have a significant adverse impact on a director's ability to perform his or her most basic duties.	1. Balance sheet • Equity • Liabilities • Non-current assets 2. Income statement • Expenses • Profit/loss • Income 3. Cash flow statement
Theme 5: Financial statement analysis This theme encompasses the Frameworks, criteria, checklists and ratios and other mathematical or statistical processes for analysing and evaluating the financial health of the organisation. Not knowing these concepts or processes will have a significant adverse impact on a director's ability to perform his or her most basic duties.	1. Ratios • Liquidity ratios • Profitability ratios • Financing ratios 2. Trends 3. Variations



The blue columns show the number of times each theme was mentioned by the panel of experts. The red line shows the number of experts that identified each theme.